RAM TAMARA & MADHURI SARIPALLE analyse why household bank deposits have been declining

Their suggested policy fix is to free the interest rate on savings deposits

In slow motion

INDIA has one of the highest savings rates in the world—gross domestic savings as a percentage of GDP is at an impressive 34%—second only to China, where savings are 50% of GDP. The saving behaviour of Indians has been lauded as an important reason for India not bearing the brunt of the global financial crisis.

If one looks at the pattern of household savings in India, the proportion of household savings in gross domestic savings has steadily fallen from 94% in 2001-02 to 65% in 2007-08; private sector savings have increased from 16% to 23% and the proportion of public sector savings has increased from -9% to 12%. Household savings as a percentage of GDP have marginally increased from 22.1% in 2001-02 to 22.6% in 2008-09.

The household sector accounts for 57% of the total deposits of the banking sector. Of the total deposits, the household sector holds 86.1% of the savings deposits, 48.2% of the current account deposits and 52.2% of the term deposits. For the banks, deposits are a major source of funds—aggregate deposits constitute 77% of the total bank liabilities. Of these, the current account and savings account deposits (CASA) are the cheapest source of raising funds and constitute almost a third of the total deposits of the banks.

But there are indications that there might be some fundamental changes in the offing vis-à-vis household saving behaviour. As per the RBI's latest commercial bank survey, the growth rate of aggregate deposits (demand and time deposits) with scheduled commercial banks (SCBs) has been gradually declining from 24.6% in 2007 to 23.1% in 2008 to 22.4% in 2009. More importantly, the share of CASA in total deposits as well as their growth has been decelerating in all SCBs from 38.6% in 2006 to 33.2% in 2009. This trend is, however, not consistent across all types of banks. While the share of CASA in total deposits has declined in nationalised and foreign banks, the share of CASA in total deposits has generally been growing in case of private banks (barring their deceleration in the last one year).

Gross financial savings of household sector

% growth, year-on-year

	2004-05P	2005-06P	2006-07P	2007-08P	2008-09#
HH deposits with banks	12	73	13	16	14
HH deposits with non-banking companies	-11	36	-67	147	259
Shares and debentures	910	484	102	52	-78
Insurance funds	33	20	38	12	17
Pension & provident funds	9	4	23	-2	0.02

Source: RBI Annual Report, June 2009, P= Provisional #= Preliminary estimates

Two key questions emerge from the statistics presented above—(a) why is the share of CASA in total deposits decreasing, and what does this mean for the future and (b) why are private banks doing better than the nationalised and foreign banks in terms of mobilising CASA deposits?

Financial decisions are driven not only by economic factors—that lead to what is classified as rational behaviour—but to a great degree are influenced by behavioural factors that lend to the irrationality often witnessed in the real world. The rational reason for households' preference for savings deposits is, of course, the liquidity that savings deposits in CASA provide. Customers probably keep balances in bank accounts to meet their regular transaction needs—for food, clothing, shelter, transportation, education, health, entertainment, etc; to pay for planned expenditures; acquisition of durable goods, saving for social occasions or for a rainy day.

However, the lack of highly evolved financial markets—lack of savings instruments and access to credit—is an additional cause that affects the quantity of balances held in savings deposits in the not so financially developed economies. These factors cut across countries that are at different levels of development.

A case in point is China. Limited consumer finance and increasing private (as opposed to public) burden of housing, education and health expenditures have been cited as important reasons behind the high household savings rate in China (BIS Working Paper, No 312; IMF Working Paper No 145).

The reasons for the decline in household bank deposits can be the result of deepening of financial markets, i.e., greater access to credit, availability of alternate savings instruments like equities, mutual funds, government securities and bonds and lastly, an increased financial awareness. In India, retail credit has recently declined but credit to finance durable goods acquisition has increased dramatically.

Recent trends show a phenomenal growth of household deposits with non-banking companies and investment in shares and debentures (barring 2008-09).

While the deepening of financial markets will continue to chip away at the bank deposits held by households; with financial inclusion, new rural/semi-urban customers will be brought into the fold of the banking network. However, banks would have to compete with other financial institutions, primarily microfinance institutions for these deposits. Therefore, the banks have to put in place sound marketing strategies that will help them mobilise deposits in a cost-efficient manner.

This goes directly into the next question—what explains the performance of private banks with respect to CASA? The number of private banks has grown dramatically in the last 10 years. ICICI, a forerunner, is now the second-largest bank in India. Private banks have pursued aggressive marketing strategies to attract a new class of customers, the young professionals. As per the findings of Centrum Research (June 2009), public sector banks have only 32% of their customers under the age of 40, whereas the share of young customers in private banks is over 60%.

Private banks have 57% of their branches in urban and metro areas as opposed to 43% for public sector banks. They also have superior technology, offer better cash management services and are proactive in identifying new growth opportunities in areas such as insurance, asset management and international expansion. Public banks have only recently started to venture into non-banking businesses.

While ensuring easy access to credit meets the liquidity needs of households, one also needs to emphasise savings in bank deposits. Attracting new customers through effective marketing can go only so far.

To encourage households to hold larger balances in banks, one policy prescription might be to free the interest rate on savings deposits. Interest paid by banks on balances held in savings accounts is fixed by RBI at 3.5%, while no interest is paid on balances held in current accounts. Given the current rate of inflation that is higher than the interest rate, the customer loses money in real terms (inflation adjusted) by holding balances in CASA. Yet, a considerable amount of savings are held in CASA. This is not a phenomenon that is unique to India or to China, but is true even in countries such as the US.

To sum up, policymakers need to address the decline in savings, a trend that may continue if incentives are not provided to encourage more savings with the banks. This will serve the twin objectives of helping banks mobilise cheaper funds and ensuring that household savings are not diverted to speculative behaviour.

Ram Tamara is with Nathan Economic Consulting India Private Limited. This article is coauthored with his colleague Madhuri Saripalle. Views are personal